produce approximately $3.8 billion access reduction. And we think the UNE data would support that.

We also think, based on the record, in terms of what the local exchange companies filed in April of 1998, suggest that their rate of return each year has been going up by a significant amount even after each year money is taken out of the system. And the last it was, the aggregate rate of return was over 15 percent. Some LEC's it's 20 percent.

And that's what happens. And I'm not saying this is a pejorative way, is when you're a monopoly and you're growing at the industry, and we have a wonderful telecommunications industry that has double digit minute growth and has significant line growth, significant second line growth, it's a wonderful industry. And so, what you see is unit prices being cut, but the aggregate industry demand growing at a healthy clip. Thus, more revenues being produced.

MS. HOGERTY: Okay. Mr. Brown, you had suggested that essentially, rebalancing is necessary because you fear that competition -- in fact, I think you said that competition is beginning to take place. And that is going to compete away some of your rates requiring more support for universal service.

MR. BROWN: Yes.

MS. HOGERTY: What if this competition does not develop and a large fund is developed?

MR. BROWN: Okay. As I mentioned this morning, where competition isn't developing is for residential customers. And my hypothesis is because they are priced less than cost.

I was reading a report last week written by Jack Grubman, an analyst for Solomon, Smith Barney, where he noted that in the first quarter of 1998, the CLEC's collectively gained more access lines than the ILEC. I'm going from memory, but it's something like 490,000 versus 460,000. And he also noted in the long distance business, it took 10 years before the incremental growth rate of the MCI and the new entrants approached the growth rate of AT&T.

So, I think we've really got two markets going on here. We've got the residential market that everybody's wondering why aren't we seeing the competition. But you've also got the business market, the dense downtown areas. Go down on M street, you can see stenciled on the street where MFS and others are cutting the streets to lay their fiber. These are the rich veins of war in the telecommunications market, and they're where a lot of the implicit support is coming from.

And the competition is doing very well there, I think, as Mr. Grubman's analysis shows. And frankly, that's where most of the implicit support is coming from today. As I mentioned earlier, you take western states, we've got access charges that are six, seven cents a minute on each end, and the interstate we're now down two or lower. So, the business rates are three to four times the residential rate. That's where we're seeing the damage right now. And that's what is supporting, you know, the over $50 and over $100 customers.

And that's, you know, why we've kind of sent up a flare and said, "There's a problem here that somebody's got to do something about because we're two years into this thing, and you know, we've drilled holes in the bottom of this bucket, and pretty soon we have to start putting something back in the bucket or we're going to have trouble."

MS. HOGERTY: If it's true that returns are above normal levels, as many have alleged, I mean, why is there any rush to do this?

MR. BROWN: Okay. Joel referenced the 1997 earnings level for U.S. West that happens to be 15.4 percent for the whole year. In the middle of 1997, we had collectively for the industry, a $1.7 billion rate cut. Looking just at my company, that drops to 13.6 roughly. And regulatory returns could be a little misleading if you recompute that second half using the same depreciation rates that we used for financial reporting purposes. Just make that change. It drops the earnings down to 11.24 percent.

So, I mean, it's debatable. Are we earning too much? But I would suggest that under price caps, even that isn't the relevant question. Price caps were supposed to spur innovation, productivity, investment, new services. And I think, frankly, price caps are working pretty well.

MS. HOGERTY: Joel?

MR. SHIFFMAN: Yeah. Both Mr. Lubin's comments as well as Glenn Brown's comments seem to be making the assumption that additional USF money either is or is not needed for companies. And I guess our point is that, we're not proposing to the extent that additional monies received that those go to companies. We're proposing that there not be any influence. But we believe that this money is needed to keep rates comparable.

The simple fact that rates in most jurisdictions, revenues exceed forward looking costs does not in any speak to the issue as to whether or not rates are comparable. You could have rates -- you could have every jurisdiction having revenues exceed forward looking costs or even revenues exceed embedded costs. That does not, in any way, speak to the issue of comparability or reasonableness at the rate levels.

So, when we talked about the need for extra universal service money, we're talking about it's basically, not being needed by the companies, but it's needed by the customers of those companies as an offset against existing rate levels to keep their rates in rural areas comparable with rates in rural areas.

MS. HOGERTY: Mr. Cooper, you have talked about -- Dr. Cooper, you have talked about -- the only one who talked about possibly reducing the subscriber line charge. Isn't it true that when that was put into effect, the common line and the interstate jurisdiction was divided 50/50? That the interexchange carrier is directly charged and the other half is charged to the customer?

MR. COOPER: Yes.

MS. HOGERTY: Okay. Is that division still exist?

MR. COOPER: Well, one of the things that's clear about loop costs since we arrived at the number of 350 is that they've been declining. I think it was last year around this time that I said that the -- it's quite clear that the ugly duckling of the industry for decades had been the loop. Everything else is getting cheaper. Switching was getting cheaper, and the loop was just sort of assumed that it's cost never went down.

Over the past three or four years, I've been in proceedings in which telephone company witnesses have admitted that with digital and loop gain and a variety of technologies, the cost of the loop has been declining dramatically, 30, 40 percent at least, and maybe even more.

The SLC has not. It's actually, probably, the only element since 1985 or 1986 that's gone up in the bill after the first round of rate increase post-divestiture, when everything else has gone down. So, that if you look back over the past decade, the SLC has been stuck there and not been the beneficiary of any rate reduction.

The way -- and the Chairman asked me this or I mentioned this during the break. The fundamental point I want to make about the SLC is that if you find as Mr. Lubin has suggested, increased productivity, which means the price of the loop could come down, and therefore the price of the SLC could come down, that creates the room that you're looking for to raise some universal service funds. So, that we can have all of these good programs.

And let me be clear. CFA supports all these programs, and we support the programs. We need to find a way to fund them so that people don't end up with an increase in their bill. And that's the way I have suggested is that you can lower the SLC and tell people, "Stop writing to those checks to the local companies, and start writing them to the universal service fund administrator." I end up with the same bill and I get my good programs.

MS. HOGERTY: Isn't that also true that the portion that's charged to the interexchange carrier just in relevant terms of the entire cost -- of the embedded cost, is much less now than it was when the 50/50 was put into place?

MR. COOPER: Yes. As we continually reduce access charges and don't reduce the loop, the 50/50 split goes away, and it becomes a larger share of course allocated of being recovered directly from the end user.

MS. HOGERTY: So, the customer is paying a larger --

MR. COOPER: Yes. Directly as a line item, he's paying a larger share.

MS. HOGERTY: There's been a lot of talk about rebalancing, and you seem to take the same view on competition. When is it appropriate to rebalance?

MR. COOPER: Well, one of the points I'd like to make is the Chairman asked this question about how do we move forward in terms of preserving universal service. And Mr. Lubin emphasized the forward looking economic costs.

I prefer to emphasize the loop. If we treat the loop as a common cost, the example I like to use is every one of the major companies at this table has committed that the next generation of technology and application will be XDSL. They've asked you to declare that a non-common carrier service. They want to move billions of bits over the telephone network using this new technology.

This technology is really interesting as described Spring's recent announcement. All they're going to do is put a module on the switch and a splitter on my house. And they're going to use that whole network in between. But they don't want to pay for it.

That's directly contrary to Smith v. Illinois, which is the principle that we've used in this country for 70 years. If they share those costs, when they move those millions of data bits over that network, not one change to the copper in between or the fiber in between. If you make them contribute to the facilities they use, you won't have a universal service proper, because they'll sell more and more bits, and they'll spread the costs over more and more uses.

That's the fundamental principle, I think, is crucial. We don't need to rebalance rates if we constantly force all services that use the loop to share the costs of the loop. A principle that this Commission has applied since 1930 at the insistence of the Supreme Court. And nothing change in the Act or in the court to prevent you from continuing to spread those costs.

So, that's where I see -- no need for rate rebalancing, but to tap the gold mine of the telecommunications network. As more and more applications are available, than more and more services can help pay for the fundamental infrastructure that we all use.

MS. HOGERTY: Mr. Wendling, could you explain to me the difference between your proposal and the U.S. West proposal?

MR. WENDLING: Yes. On the variable benchmark approach, in that one the scheme is not just a $30 or $25 benchmark and a $50. It is a more continuous spectrum of variability of benchmarks on that particular one. Wherein, any time you draw a single line, they're going to be -- it is a sudden shift at that one point. And it may not be equitable right at that place of where you changed.

A variable benchmark would smooth that curve out. Let's say one of your goals in deciding on what the variable benchmark ought to be is that the intrastate surcharge on revenues should never exceed four percent. By varying the benchmark in increments from one state to the next, you could more approximate, never exceeding that intrastate surcharge.

On the other hand, you could -- where you picked conversely the opposite proposal on the variable percentage, is to set the benchmark which is completely different from theirs, at one -- say, affordable benchmark nationwide, and than vary the percentage. Instead of being 25 percent, it could be 26 percent, maybe even 80 percent for a state like Wyoming where they really don't have a population density center to generate the necessary revenues to keep a intrastate surcharge down below that five percent or four percent critical mass number you might decide upon.

MS. HOGERTY: So, it pretty much kind of follows the same concept, but has more variables in it to deal with your equity concerns?

MR. WENDLING: Exactly.

MS. HOGERTY: I think that's all I have for now.

CHAIRMAN KENNARD: Okay. Thank you, Martha. Commissioner Tristani?

COMMISSIONER TRISTANI: As I said in my opening remarks, I'm interested in the way that each plan allocates responsibility between the FCC and the states. And because of that, I'm interested in the variable support approach that the Colorado Commission has put forth. And I'd like to hear from others if this could be a useful tool to allocate responsibility between the FCC and the states. And I'd like particularly to hear from Mr. Shiffman. I'd like to hear from the Arizona Commission and also from Mr. Cooper on that.

And also, I'd like to hear if Colorado has any responses to all of that.

MR. SHIFFMAN: The variable support of the Colorado petition is not -- is really a variant of the 25/75 rule except for the fact that it divides the responsibility between the FCC and the state commission on the ability to pay -- of the state to raise funds, rather than on the basis of a fixed national standard which may actually be impossible for states to pay in certain instances.

In a way the variable support, not the variable benchmark portion of the Colorado plan is remarkably similar to the ad hoc approach with one difference. The variable benchmark -- not the variable -- the variable pay approach, not the variable benchmark, uses a fixed benchmark to calculate the size of the fund. And it does that at a fairly smally defined or non-granular level, while the ad hoc approach does that -- does -- uses averages, not only over the study area but over the entire state to determine its support.

The results of the two plans are not terribly dissimilar because the Colorado approach does use statewide average costs to determine the percentage of the payout between the FCC and the states. Part of the reason why we use statewide average costs to determine the amount of the fund rather than use something like the variable payout as Colorado uses, the variable payout is kind of confusing average in one step but also by CBG analysis in another step. And we believe that that creates, in some instance, anomalous results.

And that is if you did modify the 75/25 plan, we thought to reflect the state ability to pay, that the results should determine -- that that result should not just determine the percentage of costs determined in other way that's paid out, but also should determine the total aggregate amount of costs which a state receives.

But they're not the -- at least the variable payout method of Colorado, and the ad hoc approach are not totally dissimilar. They vary with regard to the fact that the details such that what cost basis you use is better to forward looking, has not been analyzed in the variable payout approach. And some other factors. I've not been -- it hasn't been priced out as the ad hoc plan has been. But it's probably worth continued analysis of study.

MS. SCOTT: Maureen Scott, I am legal counsel for Arizona Corporation Commission, and I am sitting in on behalf of Chairman -- this afternoon. Unfortunately I would have to say I am not familiar enough with the Colorado plan to make a comment at this time, but our Commission will be submitting some late filed comments on the various other proposals that have been filed with the FCC, probably within the next week or two.

MR. COOPER: CFA has tried to stay a little bit out of the battling model, but I think there a couple of principles that we do support and have clearly been articulated by other consumer advocates in this proceeding.

And I can speak to those.

And it is worth starting from the history of 115 percent, because 115 percent which was the old way of doing things was a fundamental recognition that between 100 and 115, the states were responsible. So, it clearly shared the responsibility for the above average costs between the Federal jurisdiction and the state jurisdiction.

On the other hand, there was no upper limit. As has been pointed out, if you went way above 115, you got more from the Federal jurisdiction. It did use statewide averages, and that kept the fund smaller since every company within the state was expected to average within that state.

And if you stayed below 115 or actually, I've been in a number of proceedings over the past decade where states have fallen below the 115, and been asked, "Will you ever get any money back from the Federal jurisdiction?" And the companies would say, "No, because aggregate suburbanization, et cetera, are costs go down, and we're never going to draw from the Federal fund." And that was a pretty good program. I mean, it required some responsibility.

Does the Federal Act require us to change that program? Probably not, but the FCC has actually decided it would. It said it would stop averaging rates within the states.

If you are going to do that, I think you absolutely have to have a hold harmless. It would be an ironic twist of fate in the statute for companies to come forward over statute that had 15 paragraphs on universal service and lose support for companies that really need support, high cost companies. So, I think that's important. And you cannot let the decisions on 25 and abandoning 115 impose harm on those states.

Second principle I think is important is that universal service funds should support the core services you, yourself, have defined as eligible for support in the universal service support policy. I don't think the decision on access accomplishes that goal, because it's not part of the core services.

Thirdly, I think if you apply good principles of the cost model we're talking about between those three principles, hold harmless, a good cost model and only support the core services, I think you end up with a manageable fund. Whether it's variable -- I think the notion of variable and choosing different basis is an effort to keep the fund manageable, rather than apply principles.

I think we ought to do it the other way. We ought to apply the principles of building a good analysis of the network, apply a hold harmless principle and apply the other -- the principle of supporting of core services. And I think the responsibilities will jiggle out differently.

I've not supported or opposed any of the individual models.

MR. WELLER: I think I would just like to add, GTE is certainly very sympathetic to the concerns that have been raised by the states in terms of achieving a reasonable distribution among them. And I think that the approach that we proposed of using a series of benchmarks and different percentages in between them is essentially designed to give the Commission enough policy tools to hit the policy goals that it wants to achieve in terms of both the size of the fund and also the distribution of the fund among different states.

I think with respect to the state interstate division, the first thing to do is to ask yourself what portion of the support, both implicit and explicit is coming from interstate rates and/or mechanisms today. And that provides a starting point as to what portion of the responsibility the Federal mechanisms would need to step up to in a new environment.

As Mr. Cooper says, there's a certain amount that's coming from the explicit funding today that's coming from the Federal side. And that ought to be maintained. So, that's one item.

The second thing is there's a very large amount coming from implicit sources through interstate access charges. And there's no state program that's going to act to remove those implicit subsidies and replace them with explicit ones.

So, the remedy for that has to be a Federal program. When you add those together, I think that puts a floor underneath how large the Federal fund needs to be in order to accomplish goals that can only be accomplished through a Federal program.

Then, the third question is, in addition to that, how much funding does the Federal program supply the states that have particular distributions of costs. And we've heard various discussions of those. And again, I think that's a reasonable choice. Once an amount has been determined that represents a reasonable balance between the interest of low and high cost states that you've been hearing from the in the last few weeks, than I think those three targets can be rolled together, and a set of benchmarks that could be chosen that hit those targets.

MR. WENDLING: Just if I might, one or two clarification. Under the variable approach, where there are benchmark support, it does use different measures differently. It is a forward looking economic cost model. First, the presumption for non-rural carriers. And it is done by density zones or CBG's, something less than a wire center. I think earlier someone took a -- made a comment about providing support for condos in Beaver Creek.

We're not interested in providing support for condos in Beaver Creek or the zillion dollar homes in Aspen. The Colorado high cost fund that we just adopted doesn't support those things either. And that's why targeting the USF is very important, and doing it by those areas smaller -- certainly smaller than study areas, certainly smaller than wire centers, down to truly high cost geographic areas the important way to target it.

The notion of using the average cost or the average revenue on a state was really to look at the states internal ability to generate an internal state high cost fund. It wasn't an attempt to mish mash costs and revenues by another one of those factors of how do you vary the amount of, either the benchmark or the support. Thank you.

COMMISSIONER TRISTANI: I'm glad you brought up the condos in, I think, Beaver Creek and Aspen. It reminds me of Commissioner Ness's question this morning about should we be funding lines out to Ted Turner's ranch? And I saw very few hands that went up. If we change the location and the owner of the piece of property, let's say, to the Navajo reservation and said -- we said, "Should we be funding lines out to the Hogan?" I'd like to hear what the answers could be.

But more importantly, do any of the plans here target underserved or unserved areas? Mr. Cooper?

MR. COOPER: Since I was one of the people who said I did believe Ted Turner's line should get support, let me explain that. It's quite clear, and Joel has pointed this out that it's not that I want to support Ted Turner's line, but under Section 253(b) of the Act, I have to have reasonably comparable rates in areas that are rural and urban. And so, Ted Turner is eligible for reasonably comparable rates. He's eligible for just and reasonable rates even though I don't think he sets my cable rates that way.

But he is not eligible for the lifeline program. He's not a low income consumer. His rates are affordable, and I don't have to support him.

And the thing that concerns me about the effort to target assistance in rural areas, is we create a witch hunt for rich people or middle income people. And we figure out, how much can they afford? And that's not the way we designed some programs. And our universal service program has, in fact, included everybody, including rural areas. And I think that's an important public policy.

But I assure you I will oppose Ted Turner's effort to get lifeline assistance.

COMMISSIONER TRISTANI: Mr. Wendling?

MR. WENDLING: Yes. The notion of underserved or unserved customers, in the past in very rural high cost areas, there's been a thing called the line extension policy or construction charge the customer may be asked to pay. And quite often when you're several miles away from the nearest facility, that can be very, very expensive.

But currently in the models before the Commission, there are caps on the investment, a $15,000 per line or some kind of capital investment that might be capped there or wireless equivalent. But we looked at on an intrastate side. And I know New Mexico had a fund for customers who lived, met a specific income level that couldn't come up with the $40,000 or $50,000 of line extension charges that the utility may requested to get that back. And that was only under a fairness test about what is an obligation of the general body of rate payers to support a very high cost line.

One of the things you might think about in developing a high cost fund like we've done, is the free construction allowance that a utility must offer or a common carrier must offer a new customer, is tied to the amount to the support they're getting from USF, so that the customer at least gets that amount of free construction. If the model says it costs $100,000, they get $100,000 of free construction.

The next step that we haven't yet taken, is to address the issue that Arizona brings up. And is, should there be a separate funding available for customers for that equivalent of a construction allowance support to get them into part of the network? We didn't have enough information at that time to know how big a fund that would require, but we are continuing to investigate whether that should be part of our high cost fund.

COMMISSIONER TRISTANI: Mr. Brown?

MR. BROWN: We were impressed with the comments of the Arizona Commission and as a result of that, we included with our reply comments a copy of a paper we shared about a year ago with the FCC staff authored by Alfred Kahn, essentially looking a few years out when we really do have a competitive marketplace going. And we've got the right level of monthly support for high cost lines.

And the question is, if it costs $20,000 to extend the line and someone looks at that and says, "Okay. I get $100 a month of support," which would support that line extension if I knew it was going to be in service for 20 years.

But we also have a competitive market, and the Act tell us that support must be portable. So, we may have created a situation where we need to think about how, in the future, new line extensions in high cost areas, even for non-rural companies that today can cross-subsidize, need to be handled.

In talking with some of my friends from RUS, maybe there is a need to provide some financing or guarantee of financing. And in that case, the loop or at least the loop above some benchmark investment level itself becomes a public good. But otherwise -- and we've kind of put this on the backburner because we have some issues we got to work our way through here that are very important. But we ought to think those next few steps of how in the future, we are going to fund the construction in high cost areas, because it's a different ballgame.

COMMISSIONER TRISTANI: Mr. Shiffman?

MR. SHIFFMAN: There are two attributes that the ad hoc plan objectively address the underserved areas. And one, the embedded costs limitation -- the dynamic embedded cost limitation. That being, that if a company invest dollars to provide service in underserved areas, and that raises their average investment per loop or per line, that that will raise the standard by which the limitation on the fund is measured. So that, potentially, to the extent that there are embedded costs in those areas, don't get above the forward looking costs on the average throughout their territory. That will provide them with the financial incentive to make those investments.

The second way that the ad hoc plan addresses that issue is the dynamic hold harmless. The hold harmless is not a dollar value hold harmless but is a hold harmless which, for all companies, adopts the old high cost fund rules and gives them at least as much monies as they would have gotten under the operation of the old rules.

And to that extent, that they place new loops in service, raise their average investment per loop under the operation of the old USF or old high cost fund. They will get more money and therefore, they'll have at least some incentive to make those investments since they will be toward under the dynamic -- what I call the dynamic hold harmless provision of the ad hoc plan, the recovery of those dollars.

COMMISSIONER TRISTANI: Ms. Baldwin?

MS. BALDWIN: Yes. After we finish discussing the unserved and underserved areas, I would appreciate an opportunity to respond to some of Dr. Cooper's concerns about the Time-Warner proposal?

COMMISSIONER TRISTANI: Yes.

MS. SCOTT: Our plan -- the Arizona Corporation's Commission plan, of course, is directed to the discreet issue of the unserved and underserved customers. And that, in large part, is because it is such a big problem in Arizona. I think as the Chairman's written comments indicates that just in Citizens Navajo service area alone, they estimate conservatively, that there are at least 18,000 customers -- potential customers, living in areas without facilities. Now, that's a conservative estimate. That's just one service area of the state.

We also do not -- we do not believe that existing plans or any of the proposed plans are adequate to address this. We found in Arizona, at least, that existing incentives under the existing high cost fund and other proposals before the Commission now are not enough. And some additional incentive is needed now to get facilities into these areas, more in the nature of an up front incentive.

One other point I want to mention in this regard. There's so much focus on comparably reasonable rates. And there's another major element, I think, in the Federal Act that we're losing sight of. And that if, if you look in the same provision of the Act, it also says there must be sufficient service or reasonably comparable access to services available in all areas of the country.

And this is what our plan focuses on. Somehow these people -- this big group of people, have fallen through the cracks, and they can't get the services that --

COMMISSIONER TRISTANI: At any price. Right?

MS. SCOTT: Right. That other customers can. Thank you.

COMMISSIONER TRISTANI: Mr. Cooper?

MR. COOPER: Within the past two weeks, our comments and obligations to serve in the State of Washington, I guess a U.S. state. And we made the point, and it is consistent, actually, with the U.S. West statement here and Joel's.

Again, go back traditionally. How have we handled unserved areas? We've handled them in the averaging process. If I had a line that cost me $10,000, and I incurred those costs, if my revenues weren't adequate, I came in and I averaged my rates. I raised rates. And as long as I had an obligation to serve, and as long as I had a monopoly, I could always make that stuff come out. And more or less Joel said, we sort of incorporated that by if you have a lot of high cost loops you drive up the state costs.

U.S. West says, "But if there's competition, I can't do that anymore." And the answer is when there's competition, we'll have to change the system. And that's exactly the answer we gave them in Washington.

We understand that a day is coming when we will not be able to engage in this averaging. But it's not here yet. We should think about it, and we have offered comments to think about it. But until it's here, we don't have to do anything precipitously.

COMMISSIONER TRISTANI: Ms. Baldwin -- and you'll be the last because I would like my fellow Commissioners to be able to ask questions.

MS. BALDWIN: First, I do agree with Dr. Cooper on the last point about when competition arrives, than we can be concerned about the cost of obligation to serve. But backtracking a little bit, Dr. Cooper referred to an income-based approach to distributing high cost fund as a potential witch hunt. And I just would like to point out a few things that possibly respond to that.

One is, the fact that there's a variable discount that's based on community incomes for the schools and libraries program to insure that funds are appropriately targeted, where they're needed, I don't believe has been characterized as a witch hunt.

Secondly, perhaps I have more faith than Dr. Cooper does, in both state public utility commission and the FCC to establish objective guidelines. I'm not saying it's easy.

And that's my third point. Just because it's hard to do, I don't think it's necessarily a bad idea to engage in a plan whereby one considers affordability as well as comparability in designing a high cost program.

Thank you for the opportunity to respond.

COMMISSIONER TRISTANI: Thank you.

CHAIRMAN KENNARD: Thank you, Commissioner. We'll go now to Commissioner Baker.